Office of Chief Counsel
Internal Revenue Service

memorandum

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date: AUG 20 1999

to: Chief, Examination Division, Southwest District
Attn: William Kennedy

from: District Counsel, Southwest District, Phoenix

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ubject: [redacted]

Allocation of Purchase Price from Deemed Sale of Assets

DISCLOSURE STATEMENT

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ISSUE

Whether a reduction to Class III assets and corresponding adjustment to Class IV assets is warranted due to the taxpayer's failure to take potential collection problems into account when determining fair market value of assets.

CONCLUSION

The proposed reduction of Class III assets and corresponding adjustment to Class IV assets (amortizable under I.R.C. § 197) equal to bad debt reserve is warranted in this case.

FACTS

[redacted]'s predecessor (referred to hereinafter as "[redacted]") entered into a stock purchase agreement with [redacted] ("[redacted]") in [redacted] to purchase all the stock of [redacted], which [redacted] promptly renamed [redacted]"). The buyer and seller timely agreed to treat the stock purchase as a deemed asset sale under I.R.C. § 338. On the election form (Form 8023-A), the parties listed total Class III assets of $[redacted]. This amount consisted almost totally of two types of assets, those being factored receivables and finance contract receivables. The amounts for these items were taken directly from the seller's books as of [redacted]. These numbers purportedly reflected book value of the receivables, which we understand to mean the outstanding balances of such receivables. These numbers failed to reflect, however, allowances for credit losses (loss reserves) of $[redacted] on the seller's books, which [redacted] subsequently stated to be the starting reserve balance. Thus, for example, if a $[redacted] debt ultimately became worthless, taxpayer would deduct this amount. This was the result even if a debt were non-performing and possibly worthless at the time of the sale of [redacted] to [redacted]. Thus, a $[redacted] debt with an actual value of only a fraction of this amount due to limited collection potential would result in a deduction several times its value upon being determined worthless.

DISCUSSION

You have suggested that the [redacted] and [redacted]'s valuation of receivables failed to accurately reflect fair market value, and that its method of handling reserves unfairly benefits the taxpayer. Specifically, you suggest that face value of a receivable often does not reflect fair market value. Frankly, we view your factual conclusion as common sense, in that numerous factors can cause a debt to be worth more or less than its outstanding balance. For example, the debt of a debtor in bankruptcy would be worth less than an identical debt owed by a solvent entity. Similarly, a debt with a low interest rate attached might be valued at a lesser amount than an identical debt accruing interest at a much higher rate. Likewise, other factors might cause a receivable to be worth more or less than its remaining balance, such as remaining duration, available security or guarantors, and the economy in general.

We also agree that the taxpayer's allocation of the loss reserves defies a common sense analysis. For example, a non-performing debt of a bankrupt entity should receive a much greater allocation of loss reserves than should a performing debt of a solvent entity.

As a practical matter, (b)(7)a [redacted]

(b)(7)a [redacted]

In arriving at the above conclusion, we note that Treas. Reg. §§ 1.1060-1T(e)(1) and (4) provide rules for certain asset allocations, specifically stating that the amount allocated to an asset cannot exceed its fair market value. Such regulations further provide that the Service may use any appropriate method in challenging the taxpayer's determination of fair market value. Treas. Reg. § 1.166-1(d)(2)(i) allows deduction of only the "fair market value when received" if valued, as in the present case, when received. It is therefore improper for the taxpayer to attempt to deduct the entire balances of debts at risk at the time of purchase. To the extent that the parties cannot tell which debts might have been at risk, and therefore, should have been valued at a discount, this is primarily due to the taxpayer's failure to make a proper allocation at the time of the transaction. The parties to the deal agreed that a loss reserve of $[redacted] was appropriate, and the Service's adjustment is based on this number. (b)(7)a [redacted].

Please note, we consider the opinions expressed in this memorandum to be significant large case advice. We therefore request that you refrain from acting on this memorandum for ten (10) working days to allow the Assistant Chief Counsel (Field Service) an opportunity to comment. If you have any questions regarding the above, please contact me at (602) 207-8052.

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